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The Difficulty of a Plaintiff's Playground Being Truly "Open for Business": An Overview of West Virginia's Corporate Law Governing Derivative Lawsuits

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THE DIFFICULTY OF A PLAINTIFF'S PLAYGROUND BEING TRULY "OPEN FOR BUSINESS": AN OVERVIEW OF WEST VIRGINIA'S CORPORATE LAW GOVERNING DERIVATIVE LAWSUITS

I.	INTRODUCTION	884
II.	THE FUNDAMENTALS OF DERIVATIVE ACTIONS.....	886
	A. <i>Derivative versus direct actions</i>	887
	B. <i>State law governs the process and requirements for bringing a derivative action</i>	887
	1. Standing requirements	888
	2. Demand to the corporate board	889
	C. <i>Purpose of the regulation of derivative actions</i>	890
III.	DELAWARE LAW GOVERNING DERIVATIVE ACTIONS	890
	A. <i>Section 327 of Delaware General Corporation Law</i>	891
	B. <i>Delaware Court of Chancery Rule 23.1</i>	893
	C. <i>Delaware common law</i>	895
IV.	WEST VIRGINIA LAW GOVERNING DERIVATIVE ACTIONS	896
	A. <i>Derivative law in West Virginia under West Virginia Code Section 31-1-103</i>	897
	B. <i>West Virginia Acts 2002 Second Extraordinary Session repeals Section 31-1-103, leaving derivative actions in West Virginia to be governed by little substantive law</i>	900
	C. <i>Applicability of West Virginia Rule of Civil Procedure 23.1</i> .	902
V.	ARGUMENT REGARDING THE ENACTMENT OF RMBCA SUBCHAPTER D SECTIONS 7.40 THROUGH 7.47 IN WEST VIRGINIA.....	903
	A. <i>The evolution of the Model Business Corporations Act with respect to derivative actions</i>	904
	B. <i>Subchapter D</i>	904
	C. <i>Subchapter D provides the most extensive regulation of derivative suits</i>	907
	D. <i>Arguments for the enactment of Subchapter D</i>	909
	E. <i>The Enactment of Subchapter D and portions of former West Virginia Code Section 31-1-103 to aide West Virginia's campaign to "Open for Business"</i>	911
IV.	CONCLUSION	912

I. INTRODUCTION

Governor Joe Manchin is determined to battle West Virginia's economic deficit by improving the business climate in West Virginia.¹ In his 2005 State of the State Address, he announced that West Virginia would become "Open for Business."² Less than a year after taking office, Governor Manchin reported significant progress in the State's economic development efforts to create and preserve jobs as well as to procure the investment of more than \$115 million dollars in West Virginia.³

Since that report, Governor Manchin has continued to emphasize that the health and well-being of West Virginia citizens is contingent on economic improvement.⁴ In an effort to make financial recovery and address long-term pension debts, the Governor, executive officers, and the West Virginia State Legislature have decreased the State sales tax on groceries⁵ and have worked with insurance⁶ reform. In addition, they have engaged in tax modernization to eliminate unnecessary nuisances to businesses and are working to provide necessary cuts in corporate taxes.⁷

Because of these changes, 18,000 jobs have been created, and approximately \$3.5 billion have been invested in new business endeavors in the

¹ Joe Manchin, Governor, W. Va., W. Va. State of the State Address (Feb. 9, 2005) (transcript available at <http://www.stateline.org/live/details/speech?contentId=16616>).

² *Id.*

³ Press Release, Governor Introduces West Virginia "Open for Business" Reports (Nov. 1, 2005), <http://www.wv.gov/O4B/OFB1105.pdf>. In this report, Governor Manchin also emphasized several areas in which the state would concentrate to facilitate more economic growth, including the use of innovative technology to harness the state's resources. *Id.* In addition, he announced, among other job-creating developments in West Virginia, the construction of a \$100 million wallboard plant in Charleston, W. Va., and the relocation of International Coal Group's corporate headquarters to Wheeling, W. Va. *Id.*

⁴ Joe Manchin, Governor, W. Va., W. Va. State of the State Address (Jan. 11, 2006) (transcript available at <http://www.stateline.org/live/details/speech?contentID=83078>).

⁵ W. VA. CODE § 11-15-3a (2005).

⁶ W. VA. CODE § 33-11-4a (2005).

⁷ In the November 9, 2006 special session, lawmakers lowered the business franchise tax from 0.70 percent to 0.55 percent. W. VA. CODE § 11-23-6 (2006). Also, in 2007, the West Virginia State Legislature considered Senate Bill 750, which proposed to decrease West Virginia's 8.75 percent corporate net income tax rate to 6.5 percent. S. B. 750, 2007 78th Gen. Assem., Reg. Sess. (W. Va. 2007), available at <http://www.legis.state.wv.us>. Though Senate Bill 750 passed in the Senate, it died in a House Finance Committee on March 1, 2007. *Id.* If reconsidered, this change would make West Virginia more competitive with other states such as Virginia, where the corporate income tax rate is six percent. See George Hohmann, *Business Leaders Enthused About Tax Cut Bills*, CHARLESTON DAILY MAIL, Feb. 28, 2007, at P1A.

state.⁸ Nevertheless, as Governor Manchin stated in his 2007 State of the State address, this progress is still "clearly not enough."⁹ In an era where states engage in intense competition to attract businesses, West Virginia must continue to improve its corporate appeal. One important element of this appeal involves the state business corporations' law.

A recent study published in the *Journal of Law and Economics* found that when choosing a state in which to incorporate, businesses favored states that provided them with legal security to maintain control of their companies.¹⁰ Therefore, it is no surprise that the cardinal precept of the General Corporation Law of the State of Delaware, the lead corporate state, is that "directors [of a corporation], rather than shareholders, manage the business and affairs of the corporation."¹¹

However, frivolous derivative actions¹² often prevent directors from effectively managing their businesses.¹³ Delaware courts have found that "[b]y its very nature the derivative action impinges on the managerial freedom of directors."¹⁴ Thus, to allow corporate managers to control their businesses with reasonable freedom, Delaware provides a plethora of law governing derivative actions, which is arguably one reason businesses choose to incorporate in Delaware.¹⁵

Conversely, West Virginia offers very little substantive law governing derivative actions, leaving it extremely plaintiff friendly and hostile to corporate boards and directors.¹⁶ This situation exists because, in 2002, the West Virginia Legislature left a gaping hole in the corporate code concerning derivative lawsuits when it repealed W. Va. Code Sections 31-1-98 to 31-1-158 through the "Business Corporation Act." This Note contends that filling this pothole with a combination of former West Virginia legislation and innovative protections drafted by the Revised Model Business Corporations Act ("RMBCA") will re-

⁸ Joe Manchin, Governor, W. Va., 2007 State of the State Address (Jan. 10, 2007) (transcript available at <http://www.wv.gov/sec.aspx?Id=101>).

⁹ *Id.*

¹⁰ See Lucian Arye Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J.L. & ECON. 383, 421 (2003) (concluding that amassing anti-takeover statutes makes states more successful in the incorporation market both in retaining in-state firms and in attracting out-of-state incorporations).

¹¹ *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984).

¹² A derivative action is "[a] suit by a beneficiary of a fiduciary to enforce a right belonging to the fiduciary; esp., a suit asserted by a shareholder on the corporation's behalf against a third party (usu. a corporate officer) because of the corporation's failure to take some action against the third party." BLACK'S LAW DICTIONARY 374 (abridged 8th ed. 2005).

¹³ *Aronson*, 473 A.2d at 811.

¹⁴ *Id.*

¹⁵ See *infra* Section III.

¹⁶ See *infra* Section IV.

sult in a significant step toward enticing more businesses to incorporate in West Virginia.¹⁷

Part II of this Note will provide an overview of derivative actions in the United States with particular emphasis on typical standing requirements to bring a derivative action, and the general requirement of demanding a corporation to pursue an action before a derivative suit may be initiated by shareholders. Part III of this Note will provide a more detailed analysis of these areas and others as they are governed by statutory and common law in Delaware, where more than 308,000 companies are incorporated, and, as a result, the unemployment rate is significantly lower than the national average.

Part IV of this Note will contrast Delaware law by explaining the historical evolution of law governing derivative lawsuits in West Virginia. More precisely, Part IV of this Note describes how West Virginia law ran off track after the legislature repealed W. Va. Code section 31-1-103 and left the State with little substantive law to govern derivative actions. Finally, Part V of this Note provides three possible solutions for filling the gap in West Virginia law governing derivative lawsuits. It then identifies this Author's preferred solution and proposal that the West Virginia Legislature adopt Subchapter D of the RMBCA as well as a portion of former W. Va. Code Section 31-1-103 in order to make West Virginia competitive with corporate-friendly states such as Delaware.

II. THE FUNDAMENTALS OF DERIVATIVE ACTIONS

A sound understanding of derivative actions is imperative to the discussion at hand, and thus is addressed briefly in this portion of the Note. A derivative action is a suit initiated by a shareholder of a corporation, on the corporation's behalf, against a wrong-doing third-party when the corporation fails to take action.¹⁸ Typically, the wrong-doing third-party is a corporate director or officer who has caused harm to the corporation by engaging in misfeasance or malfeasance.¹⁹ Because the harm is caused to the entire corporation and therefore its "whole body of shareholders," the derivative suit seeks recovery for the benefit of the corporation and all of its shareholders in common.²⁰ Before bring-

¹⁷ See 2002 W. Va. Acts 2584-765.

¹⁸ See *supra* note 12.

¹⁹ *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 95 (1991) (stating that "the purpose of the derivative action [is] to place in the hands of the individual shareholder a means to protect the interest of the corporation from the misfeasance and malfeasance of 'faithless directors and managers'").

²⁰ Seth Aronson, et al. *Recent Developments in Shareholder Derivative Actions*, in SECURITIES LITIGATION & ENFORCEMENT INSTITUTE 2005, at 111, 115 (PLI Corp. Law & Practice Course Handbook Series No. 6746, 2005) (citing *Jones v. H.F. Ahmanson & Co.*, 460 P.2d 464 (Cal. 1969) ("A shareholder's derivative suit seeks to recover for the benefit of the corporation and its whole body of shareholders when injury is caused to the corporation that may not otherwise be redressed because of failure of the corporation to act. Thus, 'the action is derivative, i.e., in the

ing a derivative action, a plaintiff must consider if he has the ability and/or desire to bring a direct suit,²¹ and he must abide by the law governing derivative actions in the state in which the corporation is incorporated.²²

A. *Derivative versus direct actions*

In determining if he or she will bring a derivative action, a shareholder may find that the line between a direct and a derivative action is sometimes difficult to distinguish.²³ Unlike a derivative action, which is instituted on behalf of the corporations and its shareholders, a direct action occurs when a shareholder is personally aggrieved and is trying to recover damages from the board of directors.²⁴ In most states, two, often overlapping, exceptions allow a shareholder to bring a direct action against a corporation: "(1) where there is a special duty, such as a contractual duty, between the wrongdoer and the shareholder, and (2) where the shareholder suffered an injury separate and distinct from that suffered by other shareholders."²⁵

B. *State law governs the process and requirements for bringing a derivative action*

Shareholders who choose to bring derivative actions for reasons such as those mentioned above must determine the requirements for bringing a derivative action as mandated by state law in the state of incorporation. State law governs whether an action is direct or derivative.²⁶ In addition, the law of the state of incorporation governs the standing requirements for bringing a shareholder derivative action.²⁷

corporate right, if the gravamen of the complaint is injury to the corporation, or to the whole body of its stock or property without any severance or distribution among individual holders, or if it seeks to recover assets for the corporation or to prevent the dissipation of its assets.'").

²¹ See generally *Eisenberg v. Flying Tiger Line, Inc.*, 451 F.2d 267 (2d Cir. 1971).

²² *State v. Wilson*, 434 S.E.2d 411, 418 (W. Va. 1993) (holding that "the local law of the state of incorporation should be applied to determine who can bring a shareholder derivative suit").

²³ *Abelow v. Symonds*, 156 A.2d 416, 420 (Del. Ch. 1959) (stating that "[t]he line of distinction between derivative suits and those brought for the enforcement of personal rights asserted on behalf of a class of stockholders is often a narrow one, the latter type of actions being designed to enforce common rights running *against* plaintiffs' own corporation or those dominating it, while the former are clearly for the purpose of remedying wrongs *to* the corporations itself").

²⁴ BLACK'S LAW DICTIONARY 385 (abridged 8th edition 2005).

²⁵ 12B WILLIAM MEADE FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5911 (perm. Ed., rev. vol. 2000).

²⁶ Aronson, *supra* note 20, at 122 (citing *Sax v. World Wide Press, Inc.*, 809 F.2d 610, 613 (9th Cir. 1987)).

²⁷ *Erie R.R. Co. v. Tompkins*, 304 U.S. 64, 78 (1938) (holding that "[e]xcept in matters governed by the Federal Constitution or by acts of Congress, the law to be applied in any case is the law of the state"); *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 98-99 (1991) (holding that in a derivative action, the need for uniformity in corporate governance requires that a shareholder's

1. Standing requirements

In most states, a plaintiff has standing to bring a derivative action if it appears he or she is a shareholder who “fairly and adequately represents the interest of the stockholders similarly situated in enforcing the right of the corporation.”²⁸ To determine if a shareholder provides a fair and adequate representation, courts have considered different factors such as whether the plaintiff is a true party in interest, if the plaintiff is familiar with the litigation, the degree of control exercised by the attorney over the litigation, the degree of support offered by the other shareholders, the lack of plaintiff’s personal commitment to the action, and the remedy sought.²⁹

Courts differ in opinion about when a plaintiff is a true party in interest. Most states require a plaintiff to be a shareholder of the corporation at the time the derivative action is filed and at the time of the challenged transaction.³⁰ Requiring a plaintiff to have “contemporaneous ownership” is intended to prevent prospective plaintiffs from purchasing shares after they learn of an alleged wrong-doing to the corporation in order to bring a derivative lawsuit.³¹ Thus, this requirement protects corporations and their shareholders from potential “gold diggers.”

Some states also protect corporations by requiring a plaintiff to post bond for litigation expenses if the derivative suit fails in order to prevent frivolous suits;³² however, several of these states only require bond to be posted by plaintiffs when their interest in the corporation is relatively small.³³ Though it

standing be determined by the law of the corporation’s state of incorporation); *Gallop v. Caldwell*, 120 F.2d 90, 93 (3d Cir. 1941) (holding that a shareholder’s ability to bring a derivative action is a substantive issue, which must be determined by the law of the corporation’s state of incorporation). In comments to Section 302 of Restatement (Second) of Conflict of Laws, the Restatement explains the rationale for the application of the local law of the state of incorporation is that “[it] will usually be supported by those choice-of-law factors favoring the needs of the interstate and international systems, certainty, predictability and uniformity of result, protection of the justified expectations of the parties and ease in the application of the law to be applied.” RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 302 cmt. e (1971).

²⁸ 18 C.J.S. § 405 (May 2006) (citing *Rothenberg v. Sec. Mgmt. Co., Inc.*, 667 F.2d 958, 961 (8th Cir. 1982); *Halsted Video, Inc. v. Guttillo*, 115 F.R.D. 177, 179 (N.D. Ill. 1987); *Neusteter v. District Court In and For City and County of Denver*, 675 P.2d 1, 7 (Colo. 1984); *Camp v. Chase*, 476 A.2d 1087, 1088 (Conn. Super. Ct. 1983); *Dawson v. Dawson*, 645 S.W.2d 120, 126 (Mo. Ct. App. W.D. 1982).

²⁹ *Rothenberg*, 667 F.2d at 961; *Mills v. Esmark, Inc.*, 573 F.Supp. 169, 176 (N.D. Ill. 1983); *Roussel v. Tideland Capital Corp.*, 438 F.Supp. 684, 688 (N.D. Ala. 1977) (citing *FED. R. CIV. P.* 23.1).

³⁰ *Aronson*, *supra* note 20, at 123.

³¹ *Id.*

³² *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541, 556 (1949).

³³ *Aronson*, *supra* note 20, at 124.

once did, West Virginia substantive law currently does not require shareholders with little interest in the corporation to post bond.³⁴

2. Demand to the corporate board

Once the court dictates that a plaintiff has adequate standing to bring a derivative lawsuit, state law determines if the plaintiff must first make a demand on the corporation.³⁵ In most situations, a shareholder will be required to make a demand on the board because the corporation's directors and officers presumptively should determine if an action should be pursued on behalf of the company.³⁶ In fact, some states require a "universal demand," which mandates that before any derivative action is brought, a demand must be made to the board of directors.³⁷

If demand is made and rejected by the board, the board's decision is protected by the business judgment rule; therefore, a plaintiff making the demand may not subsequently assert that the demand is excused.³⁸ Thus, after demand is made and refused, a plaintiff may only assert that the demand was wrongfully refused.³⁹ To prove that demand was wrongfully refused, the plaintiff must meet a very high bar by pleading with particularity that the directors did not act independently or with due care.⁴⁰

When demand is excused, many states still allow a board of directors to move to dismiss a derivative suit by creating an independent committee to investigate the feasibility and desirability of the suit for the corporation.⁴¹ Courts have adopted different approaches concerning the review of the special

³⁴ See *infra* note 95 and accompanying text.

³⁵ "To satisfy the demand requirement, a complaint must 'allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires . . . and the reasons for the plaintiff's failure to obtain the action or for not making the effort.'" Aronson *supra* note 20, at 130 (citing DEL. CH. CT. R. 23.1).

³⁶ *Id.* at 129.

³⁷ To eliminate the difficulty of making case-specific determinations, the Business Law Section of the American Bar Association proposed the universal demand requirement which requires demand in all cases, without exception, and, unless the corporation would suffer irreparable injury, requires the plaintiffs to wait 90 days after making the demand, unless the demand is rejected earlier, before initiating the derivative suit. WILLIAM A. KLEIN ET AL., BUSINESS ASSOCIATIONS: CASES AND MATERIALS ON AGENCY, PARTNERSHIPS, AND CORPORATIONS 251 (Robert C. Clark et al., eds., 6th ed. 2006). At least eleven states, including Arizona, Connecticut, Georgia, Michigan, Mississippi, Montana, Nebraska, New Hampshire, North Carolina, Virginia, and Wisconsin require universal demand. *Id.*

³⁸ Auerbach v. Bennett, 393 N.E.2d 994, 1005 (N.Y. 1979) (holding that the determination of the special litigation committee foreclosed further judicial inquiry in this case because under the business judgment rule, the substantive decision was out of the reach of the court).

³⁹ *Id.* at 1003.

⁴⁰ *Id.*

⁴¹ Zapata Corp. v. Maldonado, 430 A.2d 779, 788 (Del. 1981).

committee's independence, good faith, and its bases for supporting its conclusions.⁴² Some courts exercise their own independent business judgment in determining whether a motion to dismiss an action should be granted after they find that a committee has acted independently and in good faith.⁴³ Others review only the procedures used by the special committee and hold that conclusions reached by the committee are "outside the scope" of the court's review.⁴⁴ West Virginia currently provides no substantive law requiring that demand be made on a corporation before a plaintiff may bring a derivative action.⁴⁵

C. *Purpose of the regulation of derivative actions*

State legislatures regulate derivative actions, in part, in an effort to protect businesses from frivolous lawsuits and, thus, to entice them to incorporate in their states. Frivolous lawsuits generate discovery costs and are often even settled simply to avoid further litigation costs.⁴⁶ According to Wyatt Co., a Washington consulting firm, the average cost of a shareholder suit in 1994 was \$7.7 million for a settlement.⁴⁷ It is clear that with unnecessary legal expenses this high, corporations consider the business law in a state when choosing where to incorporate.⁴⁸ Similarly, it is also not a stretch to understand that states hope to entice businesses.⁴⁹ Therefore, state legislatures regulate derivative actions to attract businesses and promote the economy.

III. DELAWARE LAW GOVERNING DERIVATIVE ACTIONS

Section II of this Note provided an overview of corporation law governing derivative actions in the United States; however, the overview is far from inclusive of all state law because corporate law is extremely state-specific. Thus, for a more detailed description of statutory and common law governing

⁴² Aronson, *supra* note 20, at 159-60.

⁴³ *Zapata*, 430 A.2d at 788-89. *See also In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 947-48 (Del. Ch. 2003) (holding that the corporate committee's motion to dismiss should not be granted where demand had been excused because the committee's independence was not established).

⁴⁴ *Auerbach*, 393 N.E.2d at 994.

⁴⁵ *See infra* Section IV.

⁴⁶ *Corporate Settlement Costs Hit Record*, WALL ST. J., March 10, 1995, at B3. *See also* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 127 S.Ct. 2499, 2504 (2007) (explaining that private security fraud actions must be regulated because "if not adequately contained, can be employed abusively to impose substantial costs on companies and individuals whose conduct conforms to the law) (citation omitted).

⁴⁷ *Corporate Settlement Costs Hit Record*, *supra* note 46.

⁴⁸ *See supra* note 10 and accompanying text.

⁴⁹ In its legislative history, one Delaware legislator commented that, "[i]f we maintain our business-friendly environment, more [businesses] will come and they will grow here." DEL. HOUSE JOURNAL, H.R. 104-6, Reg. Sess. (Del. 2000).

derivative actions, this Section examines law in Delaware, a leading corporate law state where the legislature endeavors to maintain a corporate friendly atmosphere.⁵⁰

Delaware is nicknamed "corporate capital" because more than 308,000 companies are incorporated in Delaware, including 60% of the Fortune 500 companies and 50% of the companies listed on the New York Stock Exchange.⁵¹ Companies incorporate in Delaware because it offers advanced and flexible corporate law.⁵² Delaware's law governing derivative actions is no exception because Delaware recognizes that laws governing derivative actions are necessary to limit the "potentially disruptive effects of derivative litigation on the ability of a board of directors to direct the business and affairs of a corporation."⁵³ Therefore, Delaware intentionally attempts to create a balance between "the Delaware prerogative that directors manage the affairs of a corporation with the realization that shareholder policing, via derivative actions, is a necessary check on the behavior of directors"⁵⁴

To achieve this balance and to promote business, Delaware does not prevent shareholder actions entirely, but regulates derivative law suits through statutory law, Rules of the Court of Chancery, and an abundance of case law.⁵⁵ These combined sources address, among other things, standing requirements, demand requirements and demand futility, attorney-client privilege, representation of the defendants, settlements of derivative actions, and award of attorney's fees in derivative actions.⁵⁶

A. *Section 327 of Delaware General Corporation Law*

Section 327 of Delaware General Corporation Law provides the basic standing requirement in Delaware by mandating that a stockholder must be a stockholder at the time of the alleged wrongdoing before he or she will have standing to bring a shareholder derivative action unless his shares devolved

⁵⁰ In its legislative history, the Delaware legislature recognizes that its economy is evolving to "[offer] good jobs with excellent wages and benefits" and that they must "maintain our business-friendly environment" to continue the growth. *Id.*

⁵¹ Introduction to Delaware (2002), www.netstate.com/states/intro/de_intro.htm.

⁵² Delaware Division of Corporations, Frequently Asked Questions (2007), <http://www.state.de.us/corp/faqs.shtml#numcorps/>. Businesses choose Delaware because it provides "a complete package of incorporations services." *Id.*

⁵³ *Agostino v. Hicks*, 845 A.2d 1110, 1117 (Del. Ch. 2004).

⁵⁴ *Id.*

⁵⁵ See generally DEL. CODE 8 § 327 (2007); 56 Del. Laws, ch. 50 (1967); 71 Del. Laws, ch. 339, § 73 (1998). See also DAVID A. DREXLER ET AL., DELAWARE CORPORATION LAW AND PRACTICE ch. 42 (David Colby et al., eds., 2006).

⁵⁶ See generally EDWARD P. WELCH ET AL., FOLK ON THE DELAWARE GENERAL CORPORATION LAW, GCL-XIII-1-155 (5th ed, Supp. 2007). While Welch discusses other protections provided in Delaware, those discussed in most detail are examined in this Note.

upon him by operation of law.⁵⁷ Section 327 was promulgated to prevent a plaintiff from purchasing shares to attack an alleged wrong-doing or transaction that occurred prior to his purchase.⁵⁸

Delaware courts interpret Section 327 to require that the plaintiff remain a shareholder throughout the litigation,⁵⁹ unless the wrong complained of is an ongoing wrong.⁶⁰ Similarly, a stockholder may not attack transactions which were “executed” or “consummated” prior to the date he acquired his stock.⁶¹

Delaware courts have also interpreted Section 327 to define the meaning of a shareholder and the adequacy of his representation. Though equitable owners⁶² and beneficial owners have standing to bring a derivative suit,⁶³ holders of convertible debentures, warrants to buy stock, and creditors do not.⁶⁴ In addition, while interpreting Section 327, the Delaware courts have provided the following factors to determine whether a given plaintiff will be an adequate representative in a derivative action:

[E]conomic antagonisms between representative and class; the remedy sought by plaintiff in the derivative action; indications that the named plaintiff was not the driving force behind the litigation; plaintiff’s unfamiliarity with the litigation; other litigation pending between the plaintiff and defendants; the relative magnitude of plaintiff’s personal interests as compared to his interest in the derivative action itself; plaintiff’s vindictiveness toward the defendants and, finally, the degree of support plain-

⁵⁷ DEL. CODE 8 § 327 (“In any derivative suit instituted by a stockholder of a corporation, it shall be averred in the complaint that the plaintiff was a stockholder of the corporation at the time of the transaction of which such stockholder complains or that such stockholder’s stock thereafter devolved upon such stockholder by operation of law.”).

⁵⁸ DREXLER ET AL., *supra* note 55, at § 42.03(1).

⁵⁹ *Id.* (citing *Blasband v. Rales*, 971 F.2d 1034 (3d Cir. 1992)).

⁶⁰ *Newkirk v. W.J. Rainey, Inc.*, 76 A.2d 121, 123 (Del. Ch. 1950).

⁶¹ *Id.*

⁶² *Harff v. Kerkorian*, 324 A.2d 215, 218 (Del. Ch. 1974), *aff’d in part, rev’d in part*, 347 A.2d 133 (Del. 1975); *Rosenthal v. Burry Biscuit Corp.*, 60 A.2d 106, 113 (Del. Ch. 1948); *Brown v. Dolese*, 154 A.2d 233, 239 (Del. Ch. 1960). *See also* *Gamble-Skogmo, Inc. v. Saks*, 122 A.2d 120, 121 (Del. 1956) (holding that a stockholder who owns stock in a margin account is considered an equitable owner).

⁶³ *Jones v. Taylor*, 348 A.2d 188 (Del. Ch. 1975). A beneficial owner is a person under a contract who is entitled to receive stock in the future. *Id.* at 191.

⁶⁴ *In re New Valley Corp. Derivative Litig.*, C.A. No. 17649-NC, slip op. at 6 (Del. Ch. June 28, 2004) (holders of warrants do not have standing in a derivative action); *Harff*, 324 A.2d at 219 (holders of convertible debentures do not have standing in a derivative action).

tiff was receiving from the shareholders he purported to represent.⁶⁵

Delaware courts have held that any of these factors could warrant disqualification of a plaintiff in a derivative action if defendants show that the factor(s) could prevent the plaintiff from representing the shareholders as a whole.⁶⁶

B. *Delaware Court of Chancery Rule 23.1*

Though Section 327 is the only statutory provision addressing derivative actions, the Court of Chancery provides rules as well.⁶⁷ The Delaware Court of Chancery set forth two requirements in Chancery Rule 23.1.⁶⁸ First it provides a demand requirement, which requires that a plaintiff in a derivative suit "aver the effort made to obtain action from the board of 'directors or comparable authority' or otherwise set forth the reasons for not making the effort."⁶⁹ Next, Rule 23.1 requires that dismissal or compromise of a derivative suit must be approved by the court, and if the dismissal is with prejudice, adequate notice must be given to other stockholders unless the suit

⁶⁵ *Youngman v. Tahmoush*, 457 A.2d 376, 379-80 (Del. Ch. 1983). See also *Wiegand v. Berry Petroleum Co.*, C.A. No. 9316, slip op. at 3 (Del. Ch. Dec. 5, 1989); *Scopas Tech. Co. v. Lord*, C.A. No. 7559, slip op. at 2 (Del. Ch. Nov. 20, 1984); *Katz v. Plant Indus., Inc.*, C.A. No. 6407, slip op. at 2 (Del. Ch. Oct. 27, 1981).

⁶⁶ *Youngman*, 457 A.2d at 381; *Scopas*, C.A. No. 7559, slip op. at 2.

⁶⁷ WELCH ET AL., *supra* note 56, at GCL-XIII-42.

⁶⁸ The Delaware Court of Chancery Rule 23.1 provides:

(a) In a derivative action brought by one or more shareholders or members to enforce a right of corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall allege that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share or membership thereafter devolved upon him by operation of law. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires for the directors or comparable authority and the reasons for his failure to obtain the action or for not making the effort. . . . (c) The action shall not be dismissed or compromised without the approval of the Court, and notice by mail, publication or otherwise of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the Court directs; except that if the dismissal is to be without prejudice or with prejudice to the plaintiff only, then such dismissal shall be ordered without notice thereof if there is a showing that no compensation in any form has passed directly or indirectly from any of the defendants to the plaintiff or plaintiff's attorney and that no promise to give any such compensation has been made.

DEL. CH. R. 23.1.

⁶⁹ *Id.*

was only directed to the specific plaintiff.⁷⁰ Rule 23.1 requires that before a derivative suit may be dismissed, the plaintiff must show that he or she has received no compensation from the defendant and that no promise of compensation has been made.⁷¹ Therefore the default rule is that a stockholder has no right to bring a derivative suit without first making a demand on the board of directors to bring the suit itself.⁷²

However, a shareholder may bring a derivative action by claiming that a demand would be a futile effort because the board of directors would not fairly consider the corporate need for instating the action.⁷³ To make a demand futility claim, the shareholder must meet a high bar of proving two difficult elements.⁷⁴ First, the shareholder must show that a majority of the board of directors has a personal interest in the outcome of the claim or lacks independence to make a decision regarding the claim.⁷⁵ Second, the shareholder must allege with par-

⁷⁰ WELCH ET AL., *supra* note 56, at GCL-XIII-42. In determining if a settlement is reasonable and fair, the court will consider the following factors: the validity of the claims, difficulty in enforcing the claim, the extent to which the judgment may be recovered, cost of litigation, the amount of the settlement award, and the perspectives of the parties involved. *Polk v. Good*, 507 A.2d 531, 536 (Del. 1986).

⁷¹ WELCH ET AL., *supra* note 56, at GCL-XIII-42.

⁷² *Kaplan v. Peat, Marwick, Mitchell & Co.*, 540 A.2d 726, 730 (Del. 1988).

⁷³ *Id.*

⁷⁴ *Levine v. Smith*, 591 A.2d 194, 205-06 (Del. 1991) (holding that plaintiff's demand futility complaint failed to plead particularized facts sufficient to raise a reasonable doubt that the board had acted improperly in repurchasing a large block of stock).

⁷⁵ *Id.* The shareholder may assert a director is interested by proving "he will be materially affected, either to his benefit or detriment, by a decision of the board, in a manner not shared by the corporation and the stockholders." *Seminaris v. Landa*, 662 A.2d 1350, 1354 (Del. Ch. 1995). Naming the directors as plaintiffs, without other allegations of a board's personal interest, is not sufficient. *Scopas Tech. Co. v. Lord*, C.A. No. 7559, slip op. at 4 (Del. Ch. Nov. 20, 1984) ("Plaintiffs argument that all the directors are interested because they are not covered by the Company's insurance in suits brought against them directly by the company is unavailing.").

Instead, a shareholder must assert that the directors face a "substantial likelihood of liability." *In re Baxter Int'l, Inc. S'holders Litig.*, 654 A.2d 1268, 1270 (Del. Ch. 1995) (holding that directors are interested for purposes of demand when "the potential for liability is not 'a mere threat' but instead may rise to 'a substantial likelihood.'" (citation omitted)). The shareholder may also allege that "the 'sole or primary purpose' of the challenged board action was to perpetuate the director in control of the corporation." WELCH ET AL., *supra* note 56, at GCL-XIII-85 (citing *Green v. Phillips*, C.A. No. 14436, slip op. at 9 (Del. Ch. June 19, 1996)).

If the plaintiff does not allege that the directors are interested, he may allege that the directors lack independence. A director lacks independence if he is so influenced by an interested person that his discretion "would be sterilized" by extraneous considerations. *Aronson v. Lewis*, 473 A.2d 805, 815 (Del. 1984). To determine if a director's discretion is sterilized, a court will consider not only the "power and influence of the allegedly dominating person, but . . . [also] the susceptibility of the directors to the exercise of that leverage." WELCH ET AL., *supra* note 56, at GCL-XIII-88 (citing *Zimmerman v. Braddock*, C.A. No. 18473-NC, slip op. at 27, 28 (Del. Ch. Sept. 8, 2005)).

ticularized facts that the challenged transaction failed to meet the business judgment rule.⁷⁶

C. *Delaware common law*

In addition to Section 327, Rule 23.1, and case law interpreting them, other common law provides stable guidelines for derivative actions in Delaware. For example, the Delaware Supreme Court has set forth requirements of a board in response to a demand.⁷⁷ In *Rales*, the court stated:

The task of a board of directors in responding to a stockholder demand letter is a two-step process. First, the directors must determine the best method to inform themselves of the facts relating to the alleged wrongdoing and the considerations, both legal and financial, bearing on a response to the demand. If a factual investigation is required, it must be conducted reasonably and in good faith. Second, the board must weigh the alternatives available to it, including the advisability of implementing internal corrective action and commencing legal proceedings. In carrying out these tasks, the board must be able to act free of personal financial interest and improper extraneous influences.⁷⁸

Delaware common law also provides methods for directors to terminate action where demand has been excused.⁷⁹ In *Zapata*, the court held that when pre-suit demand is excused, the corporation may form special committee to dismiss the lawsuit.⁸⁰ In determining whether to dismiss the suit, the court will inquire into the independence and good faith of the committee and the bases supporting its conclusions (i.e. reasonable investigation).⁸¹ If the court finds independence and good faith, it will exercise its own independent business judgment in determining whether a motion should be granted.⁸²

⁷⁶ *Rales v. Blasband*, 634 A.2d 927, 933-34 (Del. 1993) (holding that the second-prong of the Aronson two-part test does not apply when the board considering the demand is not the board who made the business decision). The Delaware Supreme Court has held that pre-suit demand will only be excused "if the Court of Chancery in the first instance . . . conclude[s] that the particularized facts in the complaint create a reasonable doubt that the informational component of the directors' decision making process, *measured by concepts of gross negligence*, included consideration of all material information reasonably available." *Brehm v. Eisner*, 746 A.2d 244, 259 (Del. 2000) (italics in original).

⁷⁷ *Rales v. Blasband*, 634 A.2d 927, 935 (Del. 1993).

⁷⁸ *Id.*

⁷⁹ *See Zapata Corp. v. Maldonado*, 430 A.2d 779, 788 (Del. 1981).

⁸⁰ *Id.*

⁸¹ *Id.*

⁸² *Id.*

Delaware courts provide direction on derivative suits in areas other than demand as well.⁸³

Importantly, Delaware common law also addresses the award of attorneys' fees in a derivative action.⁸⁴ For, example, in situations where the plaintiff's derivative suit is meritorious⁸⁵ and results in a benefit to the corporation, the plaintiff is entitled to attorney's fees from the settlement or judgment going to the corporation.⁸⁶

While this examination of Delaware law governing derivative lawsuits is not exhaustive, it shows that both the Delaware General Assembly and courts have outlined extensive guidelines to govern suits by shareholders on behalf of their corporation. By doing so, Delaware has provided protection for corporations from frivolous suits, while not depriving shareholders of a method for checking corporate governance and recovering when appropriate.

IV. WEST VIRGINIA LAW GOVERNING DERIVATIVE ACTIONS

As opposed to Delaware, West Virginia does not extensively regulate actions brought by shareholders to prevent costly, frivolous litigation. Prior to 2002, West Virginia provided corporations some of the same protections from

⁸³ For instance, Delaware courts adopted the "Bangor Punta" doctrine articulated by the United States Supreme Court. *Midland Food Servs., LLC v. Castle Hill Holdings V, LLC*, 792 A.2d 920 (Del. Ch. 1999); *Courtland Manor, Inc. v. Leeds*, 347 A.2d 144 (Del. Ch. 1975). Under the "Bangor Punta" doctrine, a stockholder who purchases or otherwise acquires his stock from a party who has engaged in an alleged wrong-doing to a corporation may not bring a derivative action in the name of the corporation. *WELCH ET AL.*, *supra* note 56, at GCL-XIII-71 (citing *Darley Liquor Mart, Inc. v. Smith*, C.A. No. 5783, slip op. at 3-4 (Del. Ch. June 22, 1981)). Also, common law provides that statutes of limitations are applied to derivative actions regardless of whether a claim is legal or equitable, and the statute of limitations begins when the stockholders had reason to know about the alleged wrongdoing. *Kahn v. Seaboard Corp.*, 625 A.2d 269, 274 (Del. Ch. 1993).

⁸⁴ *Polk v. Good*, 507 A.2d 531, 536 (Del. 1986).

⁸⁵ The standard for a "meritorious" claim is as follows:

A claim is meritorious within the meaning of the rule permitting fees for counsel if it can withstand a motion to dismiss on the pleadings if, at the same time, the plaintiff possesses knowledge of provable facts which hold out some reasonable likelihood of ultimate success. It is not necessary that factually there be absolute assurance of ultimate success, but only that there be some reasonable hope.

Chrysler Corp. v. Dann, 223 A.2d 384, 387 (Del. 1966).

⁸⁶ *WELCH ET AL.*, *supra* note 56, at GCL-XIII-138 (citing *In re Appraisal of Shell Oil Co.*, C.A. No. 8080, slip op. at 11 (Del.Ch. July 20, 1992), *aff'd*, No. 375, 1992 (Del. Nov. 24, 1992) (citing *Trs. v. Greenough*, 105 U.S. 527 (1882))). To determine the amount of attorney's fees that should be awarded to the plaintiff, the court considers the following factors: the benefit of the suit to the shareholders, the time and efforts spent by the plaintiff's attorney in connection with the suit, if the attorney's pay was based on a contingency fee, the difficulty of the litigation, and the attorney's skill and experience. *In re Abercrombie & Fitch Co. S'holders Derivative Litig.*, 886 A.2d 1271, 1273 (Del. 2005).

frivolous derivative actions that Delaware and the Model Business Corporations Act ("MBCA") currently do. Former West Virginia Code Section 31-1-103 addressed standing, attorney's fees, and even a security requirement for shareholders with little stake in an action.⁸⁷ However, in 2002, the West Virginia Legislature repealed Section 31-1-103, leaving West Virginia with only common law to substantively govern derivative actions.

A. *Derivative law in West Virginia under West Virginia Code Section 31-1-103*

Before the enactment of the "Business Corporation Act" in 2002, derivative lawsuits were governed by West Virginia Code Section 31-1-103.⁸⁸ That provision of the West Virginia law governing corporations required that a plaintiff be "a holder of record of shares or of voting trust certificates thereof at

⁸⁷ W. VA. CODE § 31-1-103 (2001). The former code governing derivative actions stated:

No action shall be brought in this State by a shareholder in the right of a domestic or foreign corporation unless the plaintiff was a holder of record of shares or of voting trust certificates therefor [sic] at the time of the transaction of which he complains, or his shares or voting trust certificates thereafter devolved upon him by operation of law from a person who was a holder of record at such time.

In any action hereafter instituted in the right of any domestic or foreign corporation by the holder or holders of record of shares of such corporation or of voting trust certificates therefor [sic], the court having jurisdiction, upon final judgment and a finding that the action was brought without reasonable cause, may require the plaintiff or plaintiffs to pay to the parties named as defendant the reasonable expenses, including fees of attorneys, incurred by them in the defense of such action.

In any action now pending or hereafter instituted or maintained in the right of any domestic or foreign corporation by the holder or holders of record of less than five percent of the outstanding shares of any class of such corporation or of voting trust certificates therefor, unless the shares or voting trust certificates so held have a market value in excess of twenty-five thousand dollars, the corporation in whose right such action is brought shall be entitled at any time before final judgment to require the plaintiff or plaintiffs to give security for the reasonable expenses, including fees of attorneys, that may be incurred by it in connection with such action or may be incurred by other parties named as defendant for which it may become legally liable. Market value shall be determined as of the date that the plaintiff institutes the action or, in the case of an intervenor, as of the date that he becomes a party to the action. The amount of such security may from time to time be increased or decreased, in the discretion of the court, upon showing that the security provided has or may become inadequate or is excessive. The corporation shall have recourse to such security in such amount as the court having jurisdiction shall determine upon the termination of such action, whether or not the court finds the action was brought without reasonable cause.

Id.

⁸⁸

Id.

the time of the transaction of which he complains . . .” before bringing a lawsuit against a corporation. In addition, Section 31-1-103 explained that if a judge found that an action was brought without reasonable cause, the judge could require the plaintiff(s) to pay the defendant(s) reasonable expenses, including attorney’s fees. Furthermore, Section 31-1-103 stated that in an action where the plaintiff held less than five percent of the outstanding shares or voting trust certificates, unless the shares or trust certificates had a value exceeding \$25,000, the corporate defendant had the right to require the plaintiffs to give “security for the reasonable expenses, including fees of attorneys, that may be incurred by it in connection with such action or may be incurred by other parties named as defendant for which it may become legally liable.”⁸⁹ In 1993, the Supreme Court of Appeals of West Virginia interpreted the then-governing Section 31-1-103 in *State ex rel. Elish v. Wilson*.⁹⁰ Its interpretation provided an even more restrictive view of plaintiff standing than did Delaware law at that time.⁹¹ The court indicated that participants in an employee stock ownership plan would not have standing in West Virginia when they did not hold actual title of the stock certificates.⁹² The court stated that Section 31-1-103 “requires that parties be ‘holders of record’ in order to have standing to participate in a shareholder derivative suit.”⁹³ It then looked to Black’s Law Dictionary to determine that “record owner” refers to “a person in whose name stock shares are registered on the records of a corporation.”⁹⁴ Thus, the court insinuated that if a participant in an employee stock ownership plan would not have stock shares registered in his or her name on the records of a corporation, then he or she would not have standing to bring a derivative action in West Virginia.⁹⁵

⁸⁹ *Id.*

⁹⁰ 434 S.E.2d 411 (W. Va. 1993).

⁹¹ *Id.*

⁹² *Id.* at 415.

⁹³ *Id.*

⁹⁴ *Id.* (citing BLACK’S LAW DICTIONARY 1274 (6th ed. 1990)).

⁹⁵ *Id.* The court did not ultimately decide if the plaintiffs in *Wilson* had standing to sue or were holders of record under West Virginia law because Weirton Steel, the corporation on whose behalf the plaintiffs were suing, was a Delaware corporation doing business in West Virginia. *Id.* Therefore, because the local law of the state of incorporation is applied to determine substantive standing issues, the court applied Delaware common law to make the determination of standing. *Id.* at 416. The court determined that “under the common law of Delaware as applicable to proceedings in equity an equitable owner of stock can maintain a stockholder’s derivative action” *Id.* at 418 (citing *Rosenthal v. Burry Biscuit Corp.*, 60 A.2d 106, 113 (Del. Ch.1948)). In addition, the court quoted the Annotated Delaware Code, which states:

In any derivative suit instituted by a stockholder of a corporation, it shall be averred in the complaint that the plaintiff was a stockholder of the corporation at the time of the transaction of which such stockholder complains or that such stockholder’s stock thereafter devolved upon such stockholder by operation of law.

Another West Virginia case, *Clark v. Milam*,⁹⁶ addressed shareholder standing and the statute of limitations on derivative actions when Section 31-1-103 still governed derivative actions.⁹⁷ The *Milam* court stated that because "[i]t is well-established that shareholders bringing a derivative suit do so *on behalf of the corporation*, . . . [i]t stands to reason [that] when shareholders file a derivative action, their knowledge of wrongdoing should be imputed to the corporation."⁹⁸ Therefore, the statute of limitations for the corporation runs at the time the shareholders gain knowledge of the wrongdoing.⁹⁹

The United States District Court for the Southern District of West Virginia also addressed beneficial interest in a corporation for purposes of standing in a derivative action under the former law.¹⁰⁰ In *Silling v. Erwin*,¹⁰¹ plaintiff Cyrus Silling, Jr. filed a derivative action against One Morris, a closely held company that owned and managed apartment buildings, for failing to ever declare dividends.¹⁰² The plaintiff, a son of a deceased shareholder, claimed he was a beneficial shareholder for the purposes of bringing the derivative suit against One Morris.¹⁰³ Citing to *Felsenheld v. Bloch*¹⁰⁴ and Section 31-1-103, the court agreed that "persons with a clear beneficial interest in a corporation may bring a derivative suit without being shareholders of record."¹⁰⁵ However, the court decided that the plaintiff was not a beneficial shareholder; even though he would inherit controlling interest in One Morris if he were to prevail in his present action, at the time of his filing the derivative action, he did not hold an equitable interest in the stock of One Morris.¹⁰⁶

DEL. CODE ANN. tit. 8 § 327 (1991). The court found that because the statute did not limit shareholders with standing in a derivative action to "holders of record" as West Virginia did at the time, and in light of the holding in *Rosenthal*, that under Delaware law the participants in an employee stock ownership plan had standing to bring their derivative action. *Wilson*, 434 S.E.2d at 418.

⁹⁶ 872 F. Supp. 307, 313-14 (S.D. W. Va. 1994) (holding that a shareholder derivative suit possibility did not preclude application of adverse possession doctrine).

⁹⁷ *Id.*

⁹⁸ *Id.* at 313.

⁹⁹ *Id.* at 313-14.

¹⁰⁰ *Silling v. Erwin*, 881 F. Supp. 236 (S.D. W. Va. 1995).

¹⁰¹ *Id.* at 238.

¹⁰² *Id.*

¹⁰³ *Id.*

¹⁰⁴ *Id.* at 239 (citing *Felsenheld v. Bloch Bros. Tobacco Co.*, 192 S.E. 545 (1937)). See *infra* note 131 and accompanying text.

¹⁰⁵ *Silling*, 881 F. Supp. at 239.

¹⁰⁶ *Id.* at 239-240.

B. West Virginia Acts 2002 Second Extraordinary Session repeals Section 31-1-103, leaving derivative actions in West Virginia to be governed by little substantive law

In 2000, the West Virginia Law Institute studied the West Virginia business code and recommended it be replaced by the Revised Model Business Corporations Act.¹⁰⁷ The West Virginia Legislature largely agreed with the Institute's suggestion and repealed West Virginia Code Sections 31-1-98 to 31-1-158 during the Acts 2002 Second Extraordinary Session.¹⁰⁸ It simultaneously enacted the "Business Corporations Act," a near replica of the Revised Model Business Corporations Act (RMBCA).¹⁰⁹ The "near replica" left out only one substantive section, RMBCA Section 7.40, which pertained to derivative actions.¹¹⁰ Thus, the legislature repealed the former code governing derivative actions and failed to replace it with anything.

If the West Virginia Legislature had adopted RMBCA Section 7.40, as the West Virginia Law Institute suggested, law governing derivative actions in West Virginia would be similar to that in Delaware. Like the law in Delaware, Section 7.40 of the RMBCA provided standards regulating standing and demand.¹¹¹

The Legislature did not explain its decision to exclude Section 7.40 in legislative history. However, an interview with Professor Kevin Outtersen

¹⁰⁷ W. Va. Law Institute, *West Virginia Law Institute Past Projects*, (2006) <http://www.wvu.edu/~law/wvli/pastproj.html>.

¹⁰⁸ W. Va. Code, § 31-1-103 (1988) (stating that §§ 31-1-98 to 31-1-158 were repealed by Acts 2002, 2nd Ex. Session., c. 25, effective Oct. 1, 2002). *See generally*, § 31D-1-101 et seq. (2002).

¹⁰⁹ W. Va. Code § 31D-1-101 et seq. (2002).

¹¹⁰ *See infra* note 120.

¹¹¹ Closely Held Corp Appendix A, CHCORP APP A (2006). Section 7.40 Procedure in derivative proceedings provides several protections. Section 7.40 requires that before a plaintiff brings a derivative lawsuit, he or she must be a shareholder at the time of the alleged wrong transaction or he or she must become a shareholder through transfer by operation of law from a person who was a shareholder at the time of the alleged wrong transaction. Section 7.40(e) explains that a person who is a beneficial owner is also a shareholder for the purposes of derivative actions. Furthermore, Section 7.40(b) provides that before a shareholder could bring an action, he needs to allege, with particularity, the demand he made to the corporation or why demand was excused. Section 7.40(b) also provides that if the corporation began to investigate changes in the shareholder's demand or complaint, the court could choose to delay the proceedings until the investigation is complete.

Also, as the law in Delaware, Section 7.40 governs dismissal and attorney's fees. Section 7.40(c) of the RMBCA provides that an action would not be dismissed or settled without the court's approval and that the court will consider the effect of dismissal on the shareholders before the action is dismissed. In addition, Section 7.40(d) of the RMBCA provides that if the plaintiff brings an action without probable cause and the action is terminated, the plaintiff may be required to pay the defendant's expenses and attorney's fees. Thus, it is clear that 7.40 provided similar, and with regard to attorney's fees even more, protection to corporations from derivative actions than that provided in Delaware.

provided insight.¹¹² Professor Outtersen stated, "I asked several members of the West Virginia Legislature why they failed to enact RMBCA Section 7.40 et seq. and was told that a powerful group quietly lobbied to keep the new derivative action rules out. No one would say precisely who requested the change, but they hinted that it was the West Virginia plaintiffs' bar."¹¹³

Because the West Virginia Legislature failed to enact RMBCA Section 7.40, by default, case law existing prior to the enactment of Section 31-1-102 governs derivative actions in West Virginia. Presently, derivative actions are governed by *Felsenheld v. Bloch Bros. Tobacco Co.*,¹¹⁴ which cites to the United States Supreme Court case providing a common law right of a derivative suit from 1855.¹¹⁵ In *Felsenheld*, a stockholder filed a derivative suit against a corporation and its officers and directors.¹¹⁶ The shareholder alleged that he was excluded from exercising control of the corporation, that the officers and directors had misused corporate assets for their own benefit by speculating in the stock market, and that the directors had awarded themselves excessive salaries, resulting in a loss to stockholders.¹¹⁷ The Supreme Court of Appeals of West Virginia affirmed in part, reversed in part, and remanded the case for further proceedings.¹¹⁸ More significant than the court's holding in *Felsenheld*, the court addressed the nature of the derivative suit in West Virginia twice in the case. First, it cited to a United States Supreme Court case, *Dodge v. Woolsey*, to define a derivative action.¹¹⁹ In doing so, the court defined a derivative suit as "an equity proceeding by a stockholder in a corporation for the purpose of sustaining, in his own name, a right of action existing in the corporation itself, and in which suit the corporation itself would be an appropriate plaintiff."¹²⁰

¹¹² Interview with M. Kevin Outtersen, Professor of Law, Boston University (Feb. 28, 2007). Professor Outtersen is a graduate of the University of Cambridge (LL.M.) and Northwestern University (B.S. and J.D.). He teaches courses in health care, business law and globalization.

¹¹³ *Id.*

¹¹⁴ 192 S.E. 545 (1937).

¹¹⁵ *Dodge v. Woolsey*, 59 U.S. 331 (1855).

¹¹⁶ *Felsenheld*, 192 S.E. at 546.

¹¹⁷ *Id.*

¹¹⁸ *Id.* at 554. The court held that because there was evidence that the directors used a subsidiary to trade on the stock market in certain securities of a speculative character, the circuit court should have overruled the demurrer on the claim that the directors and officers had speculated on the stock market using the corporation's assets. *Id.* at 548-49. The court also held that the circuit court committed no error in sustaining a demurrer regarding loans made to officers because all loans had been repaid to the corporation. *Id.* at 540-50. Finally, the court held that the circuit court erred by not overruling the demurrer on the allegations respecting excessive salaries and gratuities to the officers and directors. *Id.* at 552.

¹¹⁹ *Id.* at 546 (citing *Dodge*, 59 U.S. at 331-41). In *Dodge v. Woolsey*, the court provided shareholders with redress against third parties who had damaged or threatened the corporate properties and whom the corporation through its managers refused to pursue. 59 U.S. at 341.

¹²⁰ *Felsenheld*, 192 S.E. at 545-46.

In addition, the *Felsenheld* court addressed a shareholder's standing to bring a derivative action in West Virginia.¹²¹ The court stated that the shareholders in *Felsenheld* had standing to bring a derivative action "if, through [the] wrongful activities of the [defendants], the assets of the [corporation] have been materially reduced"¹²² The court also addressed the standing of a beneficiary by mandating that "[t]he doors of equity will not be closed to a cestui que trust merely because his interest in the corporation, a portion of the stock whereof constitutes the corpus of the trust, is less direct than that of a legal stockholder with certificates of stock in his own right."¹²³ Thus, the leading substantive authority on derivative actions in West Virginia (1) defines a derivative action, and (2) briefly addresses standing in a derivative action.

C. *Applicability of West Virginia Rule of Civil Procedure 23.1*

Though the West Virginia legislature repealed nearly all substantive law governing derivative actions, the West Virginia Rules of Civil Procedure still provide some protection for corporations.¹²⁴ West Virginia Rule 23.1, which is similar to the Delaware Court of Chancery Rule 23.1, was adopted by the West Virginia Supreme Court of Appeals in 1998.¹²⁵ It provides five essential protec-

¹²¹ *Id.* at 547.

¹²² *Id.*

¹²³ *Id.*

¹²⁴ West Virginia Rule of Civil Procedure 23.1 states:

In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which the plaintiff complains or that the plaintiff's share or membership thereafter devolved on the plaintiff by operation of law, and (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for the plaintiff's failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.

W. Va. R. Civ. P. 23.1 (1998). See also JAMES WM. MOORE ET AL., *MOORE'S FEDERAL PRACTICE* (3d ed. 1999) (discussing the application of Federal Rule 23.1 to substantive law).

¹²⁵ W. Va. R. Civ. P. 23.1 (1998).

tions for corporations against derivative actions.¹²⁶ First, it requires that a plaintiff bringing the derivative action be a shareholder at the time the alleged wrongdoing to the corporation.¹²⁷ Furthermore, Rule 23.1 states that the "action may not be maintained if . . . the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association."¹²⁸ Finally, Rule 23.1 provides that the plaintiff must "allege with particularity" the demand "if any" made to the board or shareholders and why such a demand was futile or why the demand was not made.¹²⁹

The provisions provided in Rule 23.1 are relevant and important; however, they are not sufficient for West Virginia to remain competitive with other business-friendly states for two reasons. First, many attorneys who influence the decisions of corporate officers may not be aware that the protection exists. When they search for laws governing derivative actions, they likely search statutory and case law. Second, even if corporate leaders are aware of Rule 23.1, the protections therein are still substandard to those offered in other states. Rule 23.1 does not require that demand be made on a corporation before a shareholder brings a derivative action nor does it allow a corporation to dismiss a suit when a majority of independent directors deem the suit frivolous. It also fails to address the allocation of attorney's fees or expenses. Thus, though Rule 23.1 provides important protections, it is still necessary that substantive law be adopted in West Virginia.

V. ARGUMENT REGARDING THE ENACTMENT OF RMBCA SUBCHAPTER D SECTIONS 7.40 THROUGH 7.47 IN WEST VIRGINIA

By examining the evolution Model Business Corporations Act and the details of Subchapter D, it is clear that adopting the well-reasoned provisions of Subchapter D, in addition to portions of former West Virginia Code Section 31-1-103, will aid West Virginia in its campaign to "Open for Business" because it will provide West Virginia with corporate-friendly law that will entice more businesses to incorporate within the state.

¹²⁶ *Id.*

¹²⁷ *Id.*

¹²⁸ *Id.*

¹²⁹ The Supreme Court of the United States ruled in 1991 that Rule 23.1 of the Federal Rules of Civil Procedure, which is very similar to Rule 23.1 of the West Virginia Rules of Civil Procedure, is only a pleading rule and "cannot be understood to abridge, enlarge or modify a substantive right." *Kamen v. Kemper Fin. Serv., Inc.*, 500 U.S. 90, 91 (1991) (citing 28 U.S.C. § 2072(b)). It explained that Rule 23.1 does not provide authority for a federal requirement of a demand, and only the substantive law being applied can create the demand requirement. *Id.*

A. *The evolution of the Model Business Corporations Act with respect to derivative actions*

Derivative actions evolved through equitable proceedings in the nineteenth century.¹³⁰ In the twentieth century, it was recognized that, while derivative actions were necessary to protect shareholders, they were “susceptible to abuse – the ‘strike suit’ or ‘blackmail by litigation.’”¹³¹ In response to this problem, the first Model Act provision regulating the derivative action, optional Section 43A of the 1960 Model Act, was promulgated.¹³² In the 1980s, the Model Business Corporations Act experienced substantial revision and is often referred to as the “Revised Model Business Corporations Act (RMBCA).”¹³³ During that time, Section 7.40 of the RMBCA governed derivative actions.¹³⁴ However, in 1990, Subchapter D, consisting of Sections 7.40 through 7.47 replaced former Section 7.40.¹³⁵

B. *Subchapter D*

Subchapter D is divided into the following seven sections: subchapter definitions, standing, demand, stay of proceedings, dismissal, discontinuance or settlement, payment of expenses, and applicability to foreign corporations.¹³⁶ Section 7.40 defines “derivative proceedings” and “shareholder.”¹³⁷ Notably, in its definition of shareholder, Section 7.40 explicitly states that a shareholder includes a beneficial owner, which is one aspect of law governing derivative actions that West Virginia Law actually currently regulates.¹³⁸

¹³⁰ MODEL BUS. CORP. ACT ANN., 3d ed. at 7-254 to -255 (Supp. 1997).

¹³¹ *Id.* at 7-255.

¹³² *Id.* “[S]ection 43A of the 1960 Model Act . . . consisted of three paragraphs: the first required a plaintiff to be an owner of the shares when the claim arose, the second authorized the court to impose the defendants’ expenses upon the plaintiff on a finding that the action was brought without reasonable cause, and the third imposed a security-for-expenses requirement for shareholders who owned less than five percent of the corporation’s shares or whose shares had a market value of less than \$25,000. In 1962 the first paragraph was amended to add the requirement that shares or voting trust certificates be held ‘of record.’” In 1969, the requirements were no longer listed as “optional.” *Id.*

¹³³ *Id.* The RMBCA is the version the West Virginia Legislature largely adopted in 2002. *See supra* notes 107-08 and accompanying text.

¹³⁴ *See supra* notes 108-11 and accompanying text.

¹³⁵ MODEL BUS. CORP. ACT introduction at xxv (2005).

¹³⁶ *Id.* at 7-82 to 7-98.

¹³⁷ *Id.* at 7-83. “In this subchapter: (1) ‘Derivative proceeding’ means a civil suit in the right of a domestic corporation or, to the extent provided in section 7.47, in the right of a foreign corporation. (2) ‘Shareholder’ includes a beneficial owner whose shares are held in a voting trust or held by a nominee on the beneficial owner’s behalf.” The official comment explains that “[i]n the context of subchapter D, beneficial owner means a person having a direct economic interest in the shares.” *Id.* at 7-84.

¹³⁸ *See supra* note 123 and accompanying text.

In addition, Section 7.41 of Subchapter D, like Section 327 of Delaware General Corporation Law,¹³⁹ requires contemporaneous ownership for standing.¹⁴⁰ The official comment to Section 7.41 explains that the contemporaneous ownership rule was maintained because it was clear, simple, and easy to apply.¹⁴¹ Section 7.41 also requires that the plaintiff must fairly and adequately represent the corporation's interests.¹⁴²

One controversial aspect of Section 7.42 of subchapter D, which is not present in former Section 7.40 or in Delaware law, is a universal demand requirement.¹⁴³ Thus, the traditional "demand required/demand excused" distinction is no longer applicable under Section 7.42.¹⁴⁴ According to the official comment, the universal demand requirement was adopted for the following two reasons: (1) to give the board of directors the opportunity to take corrective action to avoid a potential law suit, and (2) to eliminate the time and expense of litigants and the court in determining if demand is required or excused.¹⁴⁵ Under Section 7.42, a shareholder may commence an action 90 days after making demand; however, Section 7.43 stipulates that "[i]f the corporation commences an inquiry into the allegations made in the demand or complaint, the court may stay any derivative proceeding for such period as the court deems appropriate."¹⁴⁶

Section 7.44 requires that a derivative suit be dismissed if a majority of independent directors determine, in good faith and after reasonable inquiry, that the maintenance of the suit would not be in the best interest of the corporation.¹⁴⁷ In addition, similar to case law in Delaware, Section 7.45 states that "[a]

¹³⁹ See *supra* notes 57-61 and accompanying text.

¹⁴⁰ MODEL BUS. CORP. ACT 7-84 (2005). "A shareholder may not commence or maintain a derivative proceeding unless the shareholder: (1) was a shareholder of the corporation at the time of the act or omission complained of or became a share-holder though transfer by operation of law from one who was a shareholder at that time; and (2) fairly and adequately represents the interests of the corporation in enforcing the right of the corporation."

¹⁴¹ *Id.* at 7-85.

¹⁴² *Id.* at 7-84.

¹⁴³ *Id.* at 7-86. "No shareholder may commence a derivative proceeding until: (1) a written demand had been made upon the corporation to take suitable action; and (2) 90 days have expired from the date the demand was made unless the shareholder has earlier been notified that the demand has been rejected by the corporation or unless irreparable injury to the corporation would result by waiting for the expiration of the 90-day period." *Id.*

¹⁴⁴ *Id.* at xxv-xxvi.

¹⁴⁵ *Id.* at 7-86.

¹⁴⁶ *Id.* at 7-89.

¹⁴⁷ *Id.* at 7-89-7-90.

(a) A derivative proceeding shall be dismissed by the court on motion by the corporation if one of the groups specified in subsection (b) or subsection (e) has determined in good faith, after conducting a reasonable inquiry upon which its conclusions are based, that the maintenance of the derivative proceeding is not in the best interests of the corporation.

derivative proceeding may not be discontinued or settled without the court's approval."¹⁴⁸

Section 7.45 maintains that before an action may be discontinued or settled, all affected shareholders must be notified.¹⁴⁹ Section 7.46 orders that a corporation pay a plaintiff's reasonable expenses if the proceeding results in substantial benefit to the corporation.¹⁵⁰ Conversely, under Section 7.46, if the proceeding was "commenced or maintained without reasonable cause or for an improper purpose," the plaintiff will be ordered to pay the defendant's reasonable expenses.¹⁵¹ Finally, under Section 7.46 the court may order a party to pay the opposing party's reasonable expenses and attorney's fees.¹⁵² Recoverable fees include those incurred due to filings that are not "well grounded in fact, after reasonable inquiry, or warranted by existing law or a good faith argument" and expenses resulting from "an improper purpose, such as to harass or cause unnecessary delay or needless increase in the cost of litigation."¹⁵³ Lastly,

(b) Unless a panel is appointed pursuant to subsection (e), the determination in subsection (a) shall be made by: (1) a majority vote of qualified directors present at a meeting of the board of directors if the qualified directors constitute a quorum; or (2) a majority vote of a committee consisting of two or more qualified directors appointed by majority vote of qualified directors present at a meeting of the board of directors, regardless of whether such qualified directors constitute a quorum.

(c) If a derivative proceeding is commenced after a determination has been made rejecting a demand by a shareholder, the complaint shall allege with particularity facts establishing either (1) that a majority of the board of directors did not consist of qualified directors at the time the determination was made or (2) that the requirements of subsection (a) have not been met.

(d) If a majority of the board of directors consisted of qualified directors at the time the determination was made, the plaintiff shall have the burden of proving that the requirements of subsection (a) have not been met; if not, the corporation shall have the burden of proving that the requirements of subsection (a) have been met.

(e) Upon motion by the corporation, the court may appoint a panel of one or more individuals to make a determination whether the maintenance of the derivative proceeding is in the best interest of the corporation. In such case, the plaintiff shall have the burden of proving that the requirements of subsection (a) have not been met.

Id.

¹⁴⁸ *Id.* at 7-96.

¹⁴⁹ *Id.* "If the court determines that a proposed discontinuance or settlement will substantially affect the interests of the corporation's shareholders or a class of shareholders, the court shall direct that notice be given to the shareholders affected."

¹⁵⁰ *Id.* at 7-97. "On termination of the derivative proceeding the court may: (1) order the corporation to pay the plaintiff's reasonable expenses (including counsel fees) incurred in the proceeding if it finds that the proceeding has resulted in a substantial benefit to the corporation"

¹⁵¹ *Id.*

¹⁵² *Id.*

¹⁵³ *Id.*

Section 7.47 explains which portions of Subchapter D will apply to foreign corporations.¹⁵⁴

C. Subchapter D provides the most extensive regulation of derivative suits

Because substantive law governing derivative actions in West Virginia is currently reduced to one common law case and arguably some portions of cases decided between 1966 and 2002 (the portions that were not invalidated by the repeal of Section 31-1-103), West Virginia is in need of codified law to govern derivative suits.¹⁵⁵ The West Virginia Legislature is presented with several options regarding the remedy of this problem.

First, the Legislature could choose to ignore the problems created by the lack of codified law governing derivative actions in West Virginia. By doing so, the Legislature would arguably leave corporations in West Virginia open to suit by any shareholder or beneficiary regardless of their failure to bring demand on the corporation. According to the United States Supreme Court, this type of free rein by shareholder-plaintiffs on derivative actions "could, if unconstrained, undermine the basic principle of corporate governance that the decisions of a corporation—including the decision to initiate litigation—should be made by the board of directors or the majority of shareholders."¹⁵⁶

In addition, courts would be left with no guidance regarding the payment of attorney's fees or what procedures to take in the event of a settlement. Failure to codify law in this area would leave courts with a wide range of discretion and would leave both parties to face extreme uncertainty. It is this type of uncertainty that plays a role in deterring businesses from incorporating in West Virginia because it helps create an anti-business climate. Labor lawyers advise their corporate clients to either incorporate in the state in which they plan to do business or in a pro-business state such as Delaware or Nevada.¹⁵⁷ Thus, to attract more businesses, West Virginia should enact more business-friendly legislation. It should begin this endeavor by enacting substantive law governing derivative actions.

Second, the Legislature could choose to enact the one substantial Section of the RMBCA, Section 7.40, which it chose not to enact when it adopted virtually the rest of the RMBCA in 2002.¹⁵⁸ Adopting any of the provisions promulgated in the RMBCA would prove beneficial in attracting business to West Virginia because such provisions have been carefully drafted to protect the

¹⁵⁴ *Id.* at 7-98. "In any derivative proceeding in the right of a foreign corporation, the matters covered by this subchapter shall be governed by the laws of the jurisdiction of incorporation of the foreign corporation except for sections 7.43, 7.45, and 7.46."

¹⁵⁵ See *supra* notes 100-12 and accompanying text.

¹⁵⁶ *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 530 (1984).

¹⁵⁷ Labor Law Talk, *Where Should I Incorporate?*, (2005) <http://www.laborlawtalk.com/showthread.php?t=77164>.

¹⁵⁸ See *supra* notes 108 and 110 and accompanying text.

interests of both shareholders and corporations. All versions of the Model Act have been drafted and revised by the Committee on Corporate Laws of the Section of Business Law of the American Bar Association.¹⁵⁹ The Committee on Corporate Laws consists of an appointed chair and twenty-five members who are partners in law firms, inside general counsels, law and business school professors, federal and state judges, and members of the general counsel of the Securities and Exchange Commission.¹⁶⁰ In addition, in the past, a justice of the Delaware Supreme Court, a former chancellor of Delaware, a chief justice of Delaware, and a former director of the Central Intelligence Agency have also served on the committee.¹⁶¹ Not only is the committee composed of highly intelligent and capable people, but it also invites and considers comments from all interested persons after it publishes proposed changes to the Model Act in *The Business Lawyer*.¹⁶²

With much careful thought, it is not surprising that the Model Act provides reasoned solutions for preventing corporate misconduct while simultaneously protecting the corporation, and thus its shareholders, from frivolous suits and ill-intentioned plaintiffs. Section 7.40 accomplished this necessary balancing act by stipulating standing and demand requirements.¹⁶³ It also provided bright-line rules regarding dismissal and attorneys' fees.¹⁶⁴

However, with a significant increase in judicial decisions regarding demand requirements in the 1990s, the Committee on Corporate Laws replaced Section 7.40 with a more comprehensive and detailed Subchapter D.¹⁶⁵ Thus, while adopting Section 7.40 would be a reasonable alternative to an absence of codified law, it is still not as straightforward and responsive to recent problems as is Subchapter D.

Adopting Subchapter D is the third and most comprehensive option for the West Virginia legislature to provide regulations for balancing the right of plaintiff shareholders bringing derivative actions and the right of the corporation to be free from frivolous suits. Not only does Subchapter D provide the same protections as the former Section 7.0, but it also maintains a universal demand requirement.¹⁶⁶ In addition, Subchapter D outlines, in more detail, the guidelines for filing a derivative action and how important aspects of derivative actions will be governed.¹⁶⁷

¹⁵⁹ MODEL BUS. CORP. ACT ANN., 3rd ed. at xx (1997 Supp.).

¹⁶⁰ *Id.*

¹⁶¹ *Id.*

¹⁶² *Id.*

¹⁶³ *See supra* notes 111-12.

¹⁶⁴ *Id.*

¹⁶⁵ *See supra* notes 135-54 and accompanying text.

¹⁶⁶ *See supra* notes 143-46.

¹⁶⁷ *Id.*

D. Arguments for the enactment of Subchapter D

Regulation of derivative actions is necessary to prevent "self-appointed champions [who] sometimes turn out to be less than noble knights seeking only to advance the corporate interest."¹⁶⁸ In other words, regulations prevent shareholders from purporting to be protecting companies' interests while actually risking corporate well-being in furtherance of self-interest. First, standing requirements, as provided in Section 7.41 of Subchapter D, are necessary to prevent the transfer of wealth from the defendant to shareholders who should not benefit from the recovery.¹⁶⁹ The particular standing requirement in 7.41 is desirable because it is simple, clear, and easy to apply.¹⁷⁰ In addition, by requiring that the shareholder "fairly and adequately represent the interests of the corporation," Section 7.41 ensures that derivative actions are constrained to their purpose, which is "asserting the corporation's cause of action and seeking recovery for the corporation."¹⁷¹

The contemporaneous ownership requirement in 7.41 has been criticized for "being unduly narrow and technical and unnecessary to prevent the transfer or purchase of lawsuits."¹⁷² However, the drafters of the MBCA, Delaware Code Section 327, and West Virginia Code Section 31-1-103 have long imposed a contemporaneous ownership rule.¹⁷³ Where no contemporaneous ownership requirement exists, an opportunistic plaintiff could buy stock at a low price due to the harm already done to the corporation and receive a windfall recovery if the suit succeeded.¹⁷⁴ In addition, shareholder plaintiffs who purchase stock for the purpose of filing a derivative suit are likely to file meritless claims to obtain settlements.¹⁷⁵

Second, Subchapter D Section 7.42 provides a demand requirement, which is necessary to allow directors to assert necessary claims on behalf of the corporations and to weed out frivolous claims.¹⁷⁶ The official comment explains that the universal demand requirement was adopted in Section 7.42 for two reasons.¹⁷⁷

¹⁶⁸ FRANKLIN A. GEVURTZ, CORPORATION LAW, Hornbook Series, West Group 387 (2000).

¹⁶⁹ *Id.* at 394.

¹⁷⁰ *See supra* note 141.

¹⁷¹ GEVURTZ, *supra* note 168, at 387.

¹⁷² MODEL BUS. CORP. ACT ANN., 3rd ed. at 7-85 (1997 Supp.).

¹⁷³ *Id.* at 7-84.

¹⁷⁴ SOLOMON, LEWIS D. ET. AL., Corporations Law and Policy Materials and Problems, 4th ed. American Casebook Series, West Group 1037 (1998).

¹⁷⁵ GEVURTZ, *supra* note 168, at 386.

¹⁷⁶ *See supra* notes 143-45.

¹⁷⁷ MODEL BUS. CORP. ACT ANN., 3rd ed. at 7-86 (1997 Supp.).

First, even though no director may be independent, the demand will give the board of directors the opportunity to re-examine the act complained of in the light of a potential lawsuit and take corrective action. Secondly, the provision eliminates the time and expense of the litigants and the court involved in litigating the question whether demand is required.¹⁷⁸

Critics of the universal demand requirement claim that Section 7.42 provides that there can be no functional review of a demand refused determination made by independent directors.¹⁷⁹ However, under the universal demand requirement, a suit can proceed, even if the board rejects the demand, if a plaintiff can show that the “corporation would suffer irreparable injury as a result.”¹⁸⁰ Moreover, the Committee determined that “the cases in which demand is excused are relatively rare.”¹⁸¹

Universal demand is desirable because it allows a corporation to take corrective action without involving a costly law suit.¹⁸² The traditional demand standard, which allows for the plaintiff to waive demand if the demand would be futile, often results in unnecessary litigation over the claim.¹⁸³ In addition, it also results in unnecessary litigation over the futility of the demand.¹⁸⁴ It is difficult to ascertain if a demand on a board would be futile, and such litigation can be expensive.¹⁸⁵

Finally, Section 7.46 of Subchapter D addresses another critical component of derivative actions—who pays expenses and attorney’s fees.¹⁸⁶ Subchapter D provides an ideal balance of allowing plaintiffs to require when a derivative action proves beneficial to the corporation.¹⁸⁷ However, it also protects corporations from frivolous actions by requiring plaintiffs to pay reasonable attorneys fees and expenses if the court finds that “the proceeding was commenced or maintained without reasonable cause or for an improper purpose.”¹⁸⁸

Though Subchapter D appears to address the important issues involving derivative actions, it fails to provide one protection supplied in former West

¹⁷⁸ *Id.*

¹⁷⁹ Douglas M. Branson, *Recent Changes to the Model Business Corporation Act: Death Knells for Main Street Corporation Law*, 72 NEB. L. REV. 258 (1993).

¹⁸⁰ Marx v. Akers, 88 N.Y.2d 189, 196 (1996).

¹⁸¹ MODEL BUS. CORP. ACT ANN., 3rd ed. at 7-86 (1997 Supp.).

¹⁸² GEVURTZ, *supra* note 168, at 408.

¹⁸³ *Id.*

¹⁸⁴ *Id.*

¹⁸⁵ *Id.* at 410.

¹⁸⁶ See *supra* notes 150-52.

¹⁸⁷ *Id.*

¹⁸⁸ *Id.*

Virginia Code Section 31-1-103.¹⁸⁹ Section 31-1-103 permitted the corporate defendant to require that plaintiffs, holding less than five percent of shares, not exceeding a value of \$25,000, give security for the reasonable expenses, should the plaintiff become legally liable for initiating a frivolous suit.¹⁹⁰ This provision of the former West Virginia code is rational; if a wrong has been committed against a corporation, the shareholders with greater interests should initiate a derivative action. In addition, this provision provides further security for corporations from frivolous lawsuits and opportunistic plaintiffs (or plaintiffs' attorneys seeking attorneys' fees resulting from a derivative action).

E. The Enactment of Subchapter D and portions of former West Virginia Code Section 31-1-103 to aide West Virginia's campaign to "Open for Business"

While sound policy reasons support the adoption of Subchapter D and the security provision provided in Section 31-1-103 in every state, West Virginia has a particular need for such regulation. In West Virginia's struggle to attract more businesses and thus improve a struggling economy, all reasonable efforts must be taken to entice businesses to incorporate in West Virginia.

Governor Manchin's desire to promote business in West Virginia is likely an effort to increase the tax base in West Virginia and thus combat the deficit in the state treasury that began in the 1980s.¹⁹¹ The budget deficit has caused a ripple effect and deprives state programs, such as higher education, from battling state funding cuts.¹⁹² In addition, the lack of a sufficient budget, if not remedied, will make the payment of state employee benefits difficult in the near future.¹⁹³

To improve state funds without raising personal taxes, the executive branch has launched a campaign to entice business activity in the state. However, to achieve this goal, the legislative branch must cooperate not only by making the necessary tax cuts to entice businesses to incorporate within the state, but also by making the necessary changes to "The Business Corporations Act." By doing so, the legislature will make West Virginia competitive with other states, which provide attractive jurisdictions for incorporation.

In particular, West Virginia should adopt Subchapter D and portions of West Virginia Code Section 31-1-103 for two reasons. First, West Virginia should make this addition because it presently is at a disadvantage compared to other states because it essentially provides no codified protection to corporations

¹⁸⁹ See *supra* note 89 and accompanying text.

¹⁹⁰ *Id.*

¹⁹¹ Small meeting with Robert S. Kiss, former Speaker of the West Virginia House of Representatives, in Charleston, W. Va. (Higher Education Day, Feb. 16, 2005).

¹⁹² *Id.*

¹⁹³ *Id.*

from frivolous derivative actions. Second, by adopting Subchapter D and a provision requiring a security deposit from shareholders having very little interest in the corporation, the West Virginia Legislature will create a favorable scheme that is attractive to businesses.

IV. CONCLUSION

More action must be taken by the Legislature to attract corporations to West Virginia, which, in turn, would increase the tax base while creating jobs. Though the Legislature and Governor Manchin have been diligent in the campaign to “open West Virginia for business,” an oversight in the law governing derivative actions may prevent some corporations from choosing West Virginia as a state in which to incorporate. Corporate leaders may perceive a lack of codified protection from frivolous derivative actions as an invitation for plaintiffs’ attorneys to sue corporations incorporated in West Virginia. Therefore, they may decide to incorporate in other states, such as Delaware.

To prevent this, and in effort to make West Virginia a more business-friendly state, the West Virginia Legislature should adopt Subchapter D and a security provision. Subchapter D and a security provision would arguably give West Virginia the most comprehensive statutory regulation governing derivative actions in the nation and would be a step toward West Virginia becoming truly “open for business.”

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